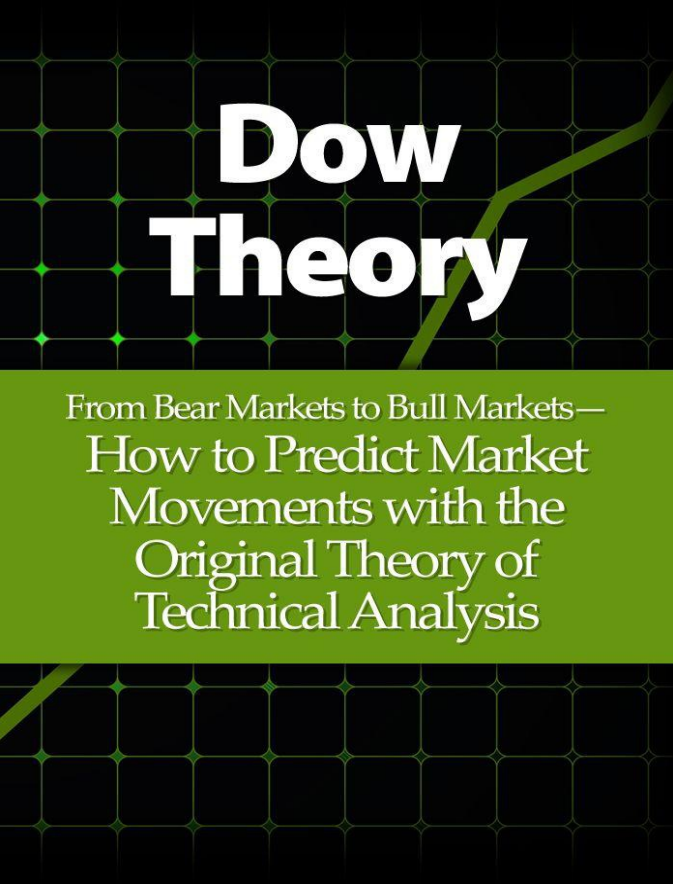


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Dow Theory

From Bear Markets to Bull Markets—
How to Predict Market
Movements with the
Original Theory of
Technical Analysis

Dow Theory

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Bull Markets— How to
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Introduction

I want to thank you very much and congratulate you for downloading the book, *Dow Theory—From Bear Markets to Bull Markets—How to Predict Market Movements with the Original Theory of Technical Analysis*.

In this book, you'll discover dow theory which is the basis of technical analysis.

By understanding this theory, you'll have a serious advantage over the vast majority of traders and investors who try (and fail) to trade based on strategies, candlestick patterns, etc. without ever taking the time understand this critical material.

By the end of this book, you'll understand the rhythmic movements of the markets—and how to take advantage of it for profitable trading and investing!

Thanks again for downloading this book, I hope you enjoy it!

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Chapter 1 - What Is Dow Theory?

If you are reading this, then you're already on the way to being better informed than many investors are. Say 'Dow' to most people and they'll understand that you are talking about the main stock index in the United States. What they won't realise is that the Dow Theory is actually a way of thinking about investment markets and rationalizing their moves and long term direction.

This investment methodology was originally voiced by Charles Dow, the father of the Dow Jones Index, and then

developed by S.A Nelson and William Hamilton in the first 25 years of the 20th century after Dow had passed away.

Chapter 2 - The 3 Assumptions of Dow Theory

Dow's theory of markets hangs on three assumptions.

The Price Trend Can't Be Manipulated

The price of a financial instrument might be manipulated in the short term but over a long time period, it is impossible to do so. It's a bit like saying "the market is bigger than any individual": which, of course, it is.

A large single investor, or an institution, or group of speculators, might be able to move the price in a desired direction either through trading volume, rumor, or news over a period of minutes, hours, or even weeks. There are examples of this in individual stocks on an almost daily basis. One of the most spectacular

efforts to manipulate markets occurred in the late 1970's/ early 1980's, when the Hunt Brothers tried to corner the market in silver and push the price skywards. For a time, about a month or two, they were successful. Silver rose to around \$60. Then it crashed to around \$10, the price where it had stood when the Hunts started buying. Another recent example came when, in the early 1990's, the UK government tried to prop up the value of sterling within the ERM system. For a while they managed the trick. Then sterling fell through the floor, and was forced out of the ERM.

Hamilton concluded that, even though it might be possible to manipulate individual stocks, the market is way too

big to be manipulated.

The Market Reflects Everything

The market averages, such as the Dow Jones, take everything into consideration, all of the time. The value of the Dow Jones Index, for example, reflects all investor sentiment – the hopes, fears, concerns, optimism, and pessimism – of all its participants. This includes the listed companies, investors, speculators, and regulators.

It also reflects everything else that is known about a market at any given moment. Interest rates, and expectations for them are known. Current business climate is well documented, as are predictions for the future. Company

earnings, and expectations, are already in the market place. The politics of the day and impending electoral change is already priced in.

Shocks to the market, unexpected events, wars, or political upheaval, may occur. These will affect the market in the short term, but then it will return to trend.

The Theory Is Not Infallible

Unlike many theorists when discussing their own theories, Dow and Hamilton came to the conclusion that the Dow Theory is not perfect. In fact, they concluded that no theory could be perfect. If there were such a market beating theory, then the investor who had it would quickly beat all markets and own everything!

What Dow and Hamilton say, however, is that the Dow Theory gives investors a way to take emotion out of trading, to identify the primary trend, and better evaluate bullish and bearish signals.

Dow Theory puts forward that there are three types of price movement.

Recognizing these movements, how they interact with each other, and then comparing to the primary trend, helps a trader to catch the big swings, the large market moves that improve investing profit many times.

The two accepted the need to watch the markets closely, and note daily and weekly, even monthly price fluctuations. Setting these against the primary trend lets an investor better pick entry and exit points.

Chapter 3 - Understanding Market Movements

There are three types of price movement, each with its specific elements and time frames.

Primary Trend

The primary trend is the broad, underlying motion of the market over an extended period. When we talk about bull and bear markets, we are really talking about the primary trend. This trend will remain in place until, well, until it changes! There are four separate signals that will identify the change of a trend.

Up-trending and Down-trending

An up-trend sees a series of higher highs and higher lows. The peaks and troughs of the Dow Jones's movements oscillate in a rhythmic increasing pattern. A downtrend sees a series of rhythmic lower highs and lower lows.

The downtrend is broken when a low is followed by a higher high, rather than a lower high, and then the next low is also higher than the previous. This change of trend is confirmed when the new higher high is broken. The market movement has turned positive, and a new bull market is in place.

Confirming Averages Confirm the Trend

When Hamilton produced the Dow Theory, the Railroads were the main driver of economic activity. Transporting goods and services to trade around the world was conducted primarily over the tracks. Hamilton contended that before economic activity could increase, raw materials would

have to be transported. So, he felt that an increase in rail activity would be the forebear of wider market activity, and used the Railroad Index as a confirmation average.

He theorized that for a new trend to be confirmed, it would have to be confirmed by both indices. If one of the indices hit a new high or low, then the other would have to quickly follow suit for the new trend to be in place, and the Dow Theory signal to be valid.

It is similar today. Many Dow theorists use the Airline Industry as the preferred confirmation index, airlines having replaced railroads in transportation importance.

Volume is King

Hamilton considered that market volume was one of the most important drivers of primary trend. In a bull market, volume should be heavier on the advances (the higher highs) than the declines (the higher lows). The opposite should hold for bear markets.

However, high volumes could also indicate the impending change of trend (remember that theories aren't infallible).

Breakout from a Trading Range

The market often travels sideways over a several months. This period would either be a period of accumulation, followed by a break to the upside, or a

period of distribution, followed by a break to the downside. Which it is can not be ascertained until the break is confirmed.

Secondary Movement

These run counter to the primary trend. For example, a bear trending market may benefit from a rally period, and a bull market may suffer a bear correction. These reactionary movements can last from days to months, but tend to be faster and sharper than the preceding primary trend. The move can be anything between 33% to 66%, with 50% the typical move.

At the end of the rally or correction, it is usual to see a period of reflection. Market volume drops, price volatility falls, and the market is considered 'dull'. This type of trading pattern augurs in a turnaround to primary trend

again.

Daily Fluctuations

Prices of individual stocks and market indices will fluctuate on a larger relative basis day to day than when viewed over a long time. Too much credence paid to these fluctuations can lead to poor investment decisions, and possible losses. A trader should always consider daily price movements in conjunction with the bigger picture.

Chapter 4 - The 3 Stages of Bull and Bear Markets

The market moves in accordance with three stages, and bull and bear markets also will have counter secondary movements.

Bull Markets

Stage 1 – Accumulation.

Similar in nature to the last reactionary rally of a bear market, pessimism still reigns supreme, but stocks are not widely held, and therefore sold in lower amounts. Corporate news is bad, and valuations will likely be at historic lows.

At this stage, stocks have begun to find a bottom and long term investors will be looking to buy value. After the first rally peters out, the bears declare the bear market to still be in place. It is when the next peak is seen higher than the first that the new bull market is confirmed, and investors move the market to stage 2.

Stage 2 – The Big Move

This stage lasts the longest of all three stages, and moves the market furthest in value. Economic conditions improve, earnings rise, confidence returns. It is easy to make money by investing it.

Stage 3 – Excess

Speculation and expectance of ever increasing asset prices takes hold. Money can't come into the market quick enough. Public share ownership is high; the number of companies going public increases, as does merger and acquisition activity. Valuations are at historic highs. This is the stage where most market bulls lose money.

The 3 Stages of Bull Markets



Bear Markets

Stage 1 – Distribution

Volumes are low, the markets appears to trend sideways. Smart money begins to get out of stocks. The public take up the slack, believing stock will still move forward. Most analysts and forecasters still predict good things for companies, stocks, and the wider market. A reaction rally will follow the first moderate fall, and this could be swiftly started and finished. It is at this stage that a lower high and then a break below the previous low will confirm the new bear market.

Stage 2 - The Big Move

The trend is firmly in place: business conditions worsen, company profits fall,

and stock prices retreat. Analysts cut estimates, and the sell off continues, dragging the market lower.

Stage 3 – Despair

Sometimes called capitulation, investors see no hope for profits from being long of stocks. Though valuations are low, investors believe the market will still head lower and shun stocks. Corporate news is bad, and the market will continue to fall until all bad news is priced in.

Chapter 5 - The Basis for Technical Analysis

Dow Theory underscores the basis for much technical analysis today. It takes into consideration fundamentals and emotions, and then attempts to allow the trader or investor to discover long-term trends and take advantage of fluctuations within those trends as the market and stocks move rhythmically inside the primary trend.

For day traders, it is of relatively little use other than to be able to identify the bigger picture within which the day trader operates. It requires investors to ignore assumptions and estimates, and to

act according to known facts.

In conclusion, using the Dow Theory should be another arrow to an investor's bow. It is not the be-all and end-all (remember, the theory isn't infallible), but should be considered as a tool to add to the others available to us.

A modern phrase that perhaps sums up the Dow Theory is this: **Make the Trend Your Friend.**

Use the Dow Theory to help spot that trend.

Conclusion

Thank you again for downloading this book!

You should now have a deep understanding of the rhythmic movement of the markets and how to take advantage of it for profitable trading and investing.

Finally, if you enjoyed this book, please take the time to share your thoughts and post a review on Amazon. It'd be greatly appreciated!

Thank you and good luck!

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